

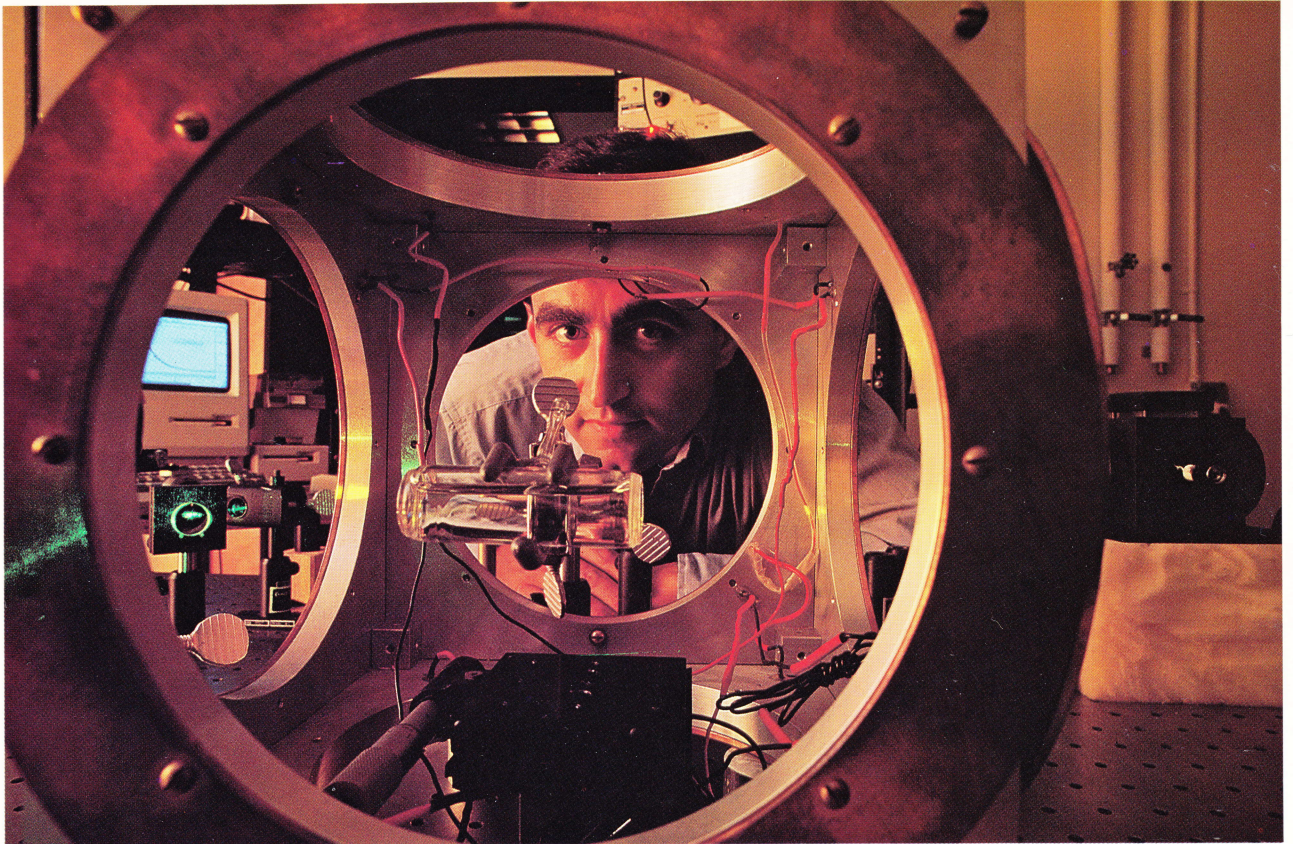


Sometimes
you have to go against
conventional wisdom
to succeed.

In 1986,
that's precisely what
Apple Computer
did.

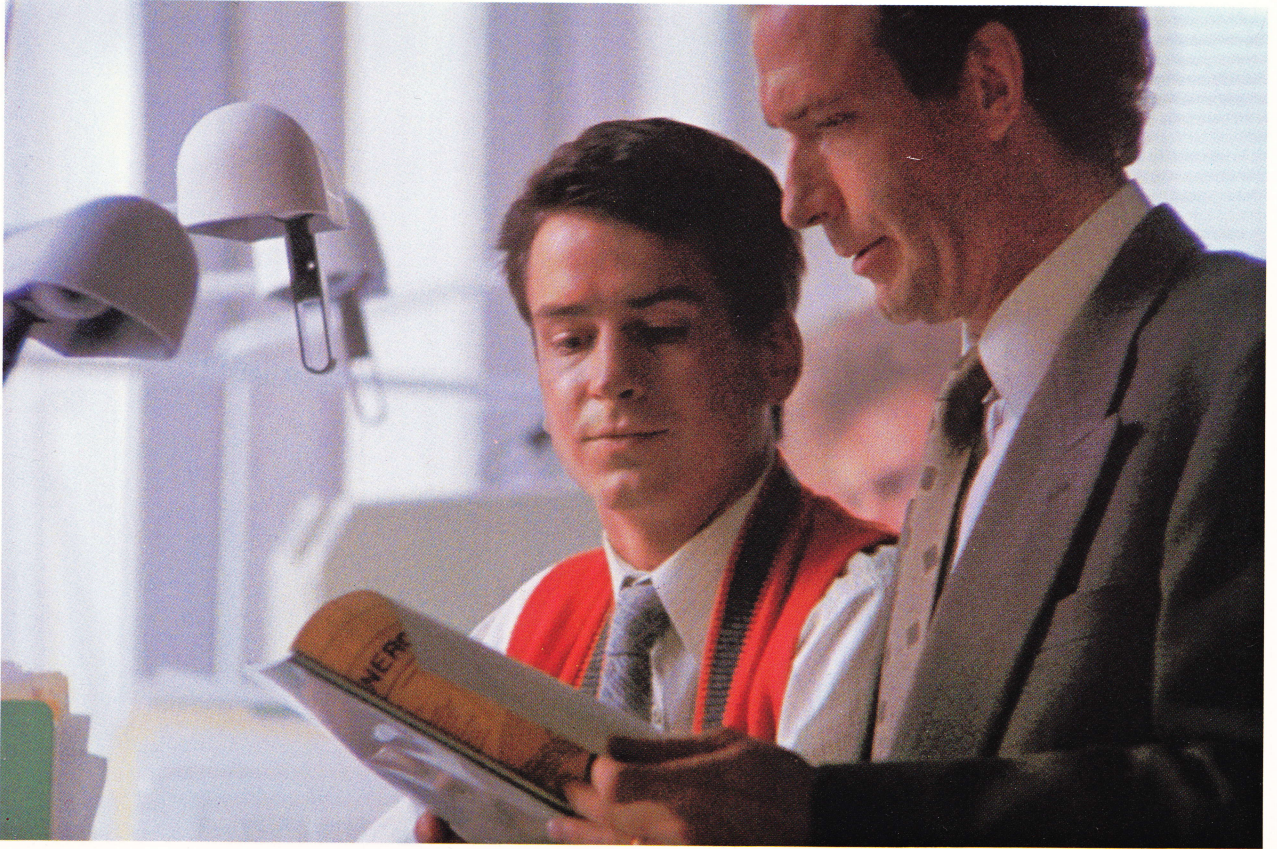
Last year, conventional wisdom held that Apple® products were not sophisticated enough for business applications.

Today, some of the most technologically sophisticated companies are using Macintosh™ computers—not just for specialized graphics applications, but for general business productivity as well.



Conventional wisdom held that desktop publishing was a narrow niche market with little significance to mainstream business users.

Today, most major computer manufacturers are attempting to enter this explosively growing market—where Macintosh and LaserWriter® technologies are the de facto standards.



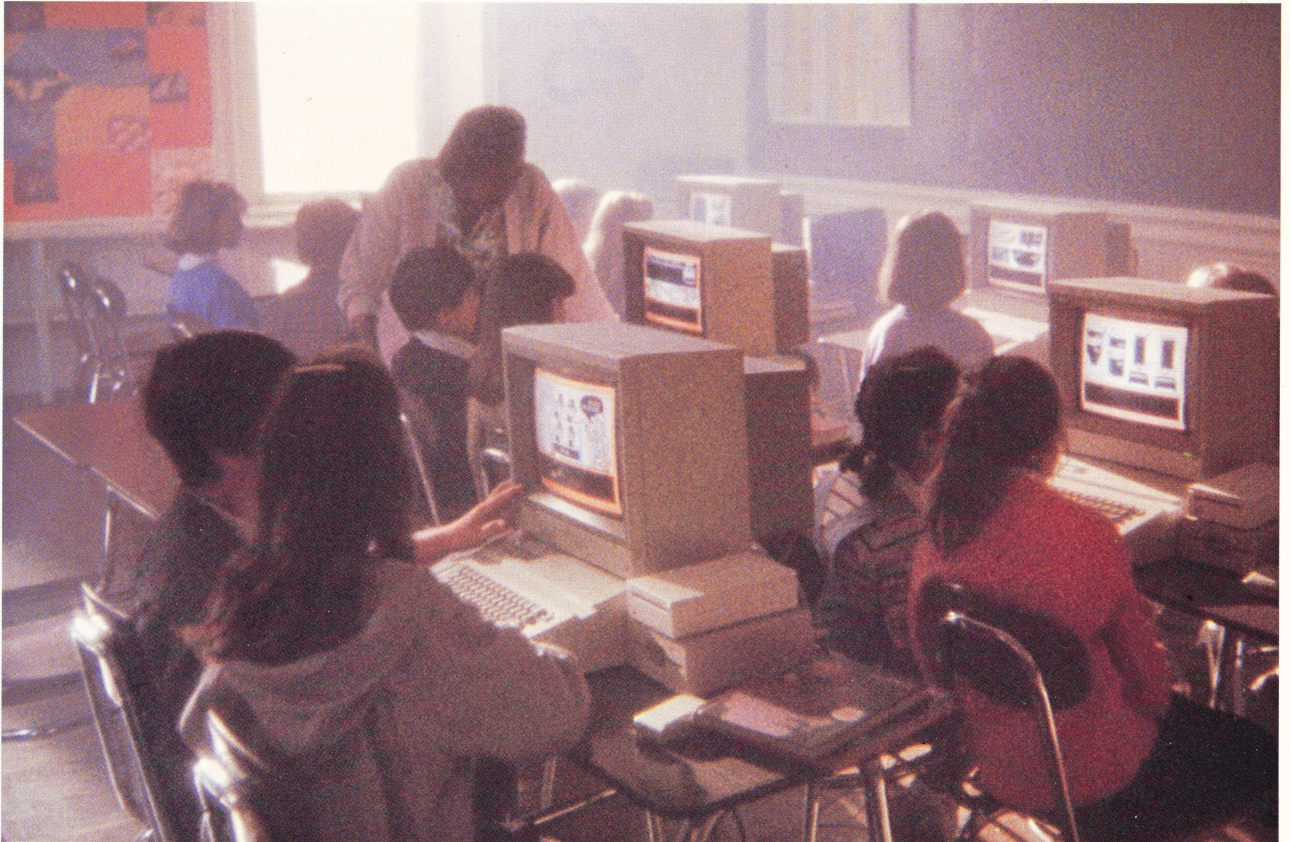
Conventional wisdom held that the Apple II product family was at the end of its life cycle, and that Apple was abandoning the computer with which the Company was founded.

Today, Apple is more committed than ever to the Apple II product family, as the new Apple IIgs™ demonstrates—and as new growth paths for the Apple IIe underscore.



Conventional wisdom held that other manufacturers would unseat Apple in the education market by implementing aggressive pricing strategies.

Today, Apple remains the recognized leader in the kindergarten through grade 12 market.



Conventional wisdom held that Apple, as a young, entrepreneurial company, would lack the resources to build and sustain its international markets.

In 1986, international sales account for 26 percent of Apple's revenues—a record percentage that Apple intends to increase in future years.



To Our Shareholders:

Just twelve short months ago, the computer industry's pundits contended that IBM held all the strategic assets, leaving Apple with nothing but strategic liabilities.

IBM's machines were "open," stimulating a lively industry in low-cost IBM-compatible computers.

Our Macintosh was "closed"—difficult for others to modify.

IBM dominated business markets, while we barely had our foot in the door.

Their technology was standard.

Ours was unique.

In fact, the experts could find only one bright spot: the outstanding leadership of the Apple II in education.

Even though in 1985 we had successfully reorganized the Company into a leaner, far more profitable organization, the experts pointed out—correctly enough—that cutting costs is not a growth strategy in an innovation-driven industry like ours.

Inside Apple, of course, we knew that the picture was never nearly this bleak. We had predicted that 1986 would be a slow or low growth year, but that we could increase earnings on the same sales.

Still, in the face of so much grim expert advice, one tends to reconsider one's philosophy.

The philosophy that founded Apple has been validated by millions of people from all walks of life, all over the world. It's a simple but powerful set of ideas and values:

We believe that if you put extraordinary computing power in people's hands, extraordinary things will happen.

We build the world's most accessible computers—to fill universal needs.

We build tools for the mind—products to help individuals create, work, learn, and communicate.

And we design them creatively—to stimulate creativity in others.

Rather than merely automating old tasks, we want to empower people to work differently. Not just faster, but better. Not just in quantity, but in quality and creativity.

And today, I am more than proud to report that sticking to Apple's original philosophy has not only seen us through challenging times, it has uniquely positioned us for the next phase of our corporate evolution.

The Macintosh Plus computer and LaserWriter Plus printer opened the door for Apple in business. In fact, they're seen as the standard for the rapidly growing desktop publishing market.

The Apple II product family continues to be a recognized leader in education, in all aspects of the curriculum, particularly for younger students.

We trimmed our U.S. dealer organization by 25 percent, but we kept our field sales force intact so we could give our best-performing dealers even better service. And while some predicted that fewer dealers would mean lower sales, sales per dealer location actually increased 15 percent.

Financially, Apple is stronger than ever. We've enjoyed a year of record profits, ending with a fourth quarter that saw profits up 47 percent from the year before. As we ended our fiscal year on September 26, 1986, net income and earnings per share had more than doubled over the year before. Net income increased 151 percent to \$154.0 million, compared to \$61.2 million a year ago. Earnings per share jumped 141 percent to \$2.39 per share, compared to \$.99 per share in fiscal 1985. All this despite the fact that sales remained essentially constant, as projected, at \$1.9 billion.

Apple has a cash balance of \$576 million, which has given us the confidence to authorize a stock repurchase program of up to 5 million shares in the open market—depending, of course, on market conditions. In addition to emphasizing our belief in Apple's future, this program is a clear indicator of Apple's financial strength.

So going against conventional wisdom has its benefits and rewards.

We also demonstrated that the reorganized Apple could do a lot more than control costs.

We introduced a number of successful new hardware and software products, starting in January with the Macintosh Plus and LaserWriter Plus.

In the early spring, we introduced the Macintosh 512K Enhanced, a more affordable version of the Macintosh Plus.

Late in the year, we strengthened the Apple II family by introducing the next generation of that technology, the Apple IIgs. We also introduced an enhanced Apple IIc that can provide up to one megabyte of memory, enabling users to work with more sophisticated software programs.

Further, we brought to market a string of new peripherals—the Hard Disk 20SC, the Apple II-compatible UniDisk™ 3.5-inch 800K disk drive, the ImageWriter® II printer, the Apple Personal Modem, and more.

Each of these products remains true to Apple's design philosophy: No matter how powerful or



Apple's Executive Staff guided the Company's course in 1986. Seated, from left, Al Eisenstat, Del Yocam, John Sculley, Dave Barram; standing, Bill Campbell, Jean-Louis Gassée, Debi Coleman, Larry Tesler, Mike Spindler.



Apple Fellows Allan E. Alcorn, Alan C. Kay, and Steve Wozniak (left to right) help Apple pursue innovative technologies. Not pictured: Apple Fellow Bill Atkinson.

sophisticated the system, keep it simple to set up and operate.

The most dramatic example of this design philosophy also happened to be one of the most successful Apple products in 1986—the AppleTalk® personal network.

As you may know, the average computer network is difficult to use, with high training and support costs.

But Apple has the first and only network solution that is as easy to learn and use as Macintosh itself. The AppleTalk network connection is built into every Macintosh (as well as every Apple IIgs), and our network “configures” itself. So linking computers, printers, and other peripherals becomes extremely simple—and economical.

To date, there are over 200,000 AppleTalk networks in place—which again proves the wisdom of unconventional wisdom.

In order to sustain Apple's high level of innovation, we must give the people within Apple every opportunity to work creatively—unafraid to experiment, to dare the impossible, to reach for the next breakthrough.

I believe that Apple's special way of doing things is the reason we attract and keep some of the best and brightest minds in the computer industry.

This is why we enjoy almost \$2 billion in sales, with approximately 5,600 employees. That's the highest sales-to-employee ratio in the computer industry.

To sustain this magnificent organization, we need to invest heavily in long-range programs.

In March, for example, we installed a \$15.5 million Cray X-MP/48 supercomputer from Cray Research, Inc. One of the largest and most powerful scientific supercomputers in the world, it enables us to simulate new computer architectures and operating systems in considerably less time than was ever before possible.

If we are to afford such investments, we can't be dragged down into the low-priced end of the computer industry.

All of which leads to why it is so important for Apple to succeed in business markets.

The business market is where computer sales are growing fastest at this time. It's also the arena in which Apple's proprietary technology can set us apart from our competitors, an arena where large multiple sales are awarded not on price alone, but on value and performance.

At Apple, we've always understood what computer enthusiasts wanted in computers. And from our infancy we've listened to educators and tried to incorporate their ideas into our products.

But it wasn't until mid-1985 that we began to understand what the business market really wants and needs, and what we as a company really have to offer. By mid-1986, we were building measurable momentum. Our customer list included more and more names from the Fortune 500, as well as small and medium-sized businesses.

I believe there are three major business areas where our proprietary technology will open more doors for us.

First, we're winning ready acceptance in technical and aerospace corporations, where the graphics prowess of the Macintosh makes it an ideal low-cost personal workstation for computer-aided design and other technical uses, as well as for general-purpose productivity. You'll find our workstations in such companies as DuPont, Hughes Company, Chevron, Motorola, General Dynamics, and Plessey, the British telecommunications giant.

The second area I see as a significant opportunity is service companies with large numbers of employees who are not computer literate. In many cases, the cost of training an employee to use a computer is greater than the cost of the computer itself. Macintosh greatly reduces training costs. That's why you'll find Macintosh systems in service companies such as the accounting firms of Arthur Young and Peat, Marwick, Mitchell, and in the branches of Seafirst Bank in Seattle.

I leave for last the business area in which we've enjoyed outstanding success—companies that need desktop publishing, the low-cost in-house production of finished printed materials made possible by the Macintosh and the LaserWriter. Our customers range from companies that are actually in publishing, such as Knight-Ridder, to marketing departments in large corporations, such as General Electric.

Whatever the primary benefit we offer to each area—low-cost computer-aided design and drafting, lower training costs, or desktop publishing—the AppleTalk connection built into every Macintosh plays an important role.

In fact, many of our Fortune 500 customers are using Macintosh computers connected with other computers. They're able to translate Lotus 1-2-3, WordStar, and other MS-DOS information directly into the Macintosh environment, where it can be further analyzed with more advanced Macintosh software and enhanced with Macintosh graphics.

This is the first phase in the development of Apple desktop communications. You should expect to see a whole new range of hardware and software products to exploit and develop the communications talents of our Macintosh family of computers.

There are three key areas where we intend to do this:

Linking Macintoshes and MS-DOS computers on AppleTalk.

Linking Macintoshes into other industry-standard networks, such as Token Ring and Ethernet.

Linking Macintoshes with IBM mainframes.

The central idea is to extend the power and transparency of Macintosh to the business workgroup.

A year ago, conventional wisdom told us to build clones. Instead, we chose to stay our course, offering business products with *meaningful differences*.

Today, computer industry gurus will tell you that the most meaningful innovation in software is taking place within the Macintosh environment.

Much of the newest advanced business software is available in an exclusive Macintosh form, with features not available in the MS-DOS versions of the same programs.

In fact, Macintosh now has everything it takes to satisfy “power users” in business—greater memory capacity, high-speed storage devices like the Hard Disk 20SC, and advanced software.

We’ve discussed why it’s important for Apple to succeed in business, and how we intend to do it. But I want to stress that our growth strategy in business will in no way lessen our commitment to our best-established market, education—or to our best-established line, the Apple II family of computers.

Throughout 1985 and 1986, we worked with educators all over the world to learn what they wanted and needed in the next generation of education computers.

They told us they wanted better computer sound and graphics in more powerful machines that would be ready for the new generation of optical media.

Yet any new computer had to be compatible with the vast library of educational software that schools already have.

Everything they told us is reflected in the new flagship of the Apple II product line, the Apple IIgs.

It’s capable of producing high-definition pictures in more than 4,000 colors; generating a full range of sound, from symphonic music to human speech; and running virtually the entire existing library of Apple II software. And, like Macintosh, it comes with a mouse.

Because compatibility is so important, we’re offering present Apple IIe owners an upgrade kit that will give their machines all the capabilities of the Apple IIgs.

We know from the enthusiasm of third-party developers that the impressive capabilities of the IIgs will stimulate a new wave of creativity in Apple II software, especially for education.

To that end, we’ve entered into a collaborative effort with the National Geographic Society and LucasFilm Ltd. to explore the effective use of optical technologies (video and compact disks) in education.

These devices can store vast amounts of information, including still and moving images and stereo sound. And they allow easy interaction—a student can take a guided tour of the Louvre, for example.

So, despite costly efforts by many of our major competitors, schools serving kindergarten through grade 12 students continue to choose Apple computers more often than any other brand.

In higher education, Macintosh continues to enjoy widening acceptance. More and more colleges and universities now require or recommend Macintosh for their students.

Throughout the year, we continued to strengthen the Apple University Consortium, an effort within individual countries through which universities and colleges are brought together to share and explore the integration of technology and education. In the United States, there are 32 Consortium members. Internationally, the number is even greater, and growing rapidly.

We believe in giving a lot to higher education. But we also receive a lot—including new ideas and new applications. Cornell and Stanford offer two examples of mainframe-to-desktop networks that serve an entire university, from senior administrators to first-year students. The lessons we're learning on campus can translate easily to business.

Apple's Office of Special Education represents a special commitment to work with educational institutions and human services organizations to identify and assist the computer-related needs of disabled persons. I am especially proud of the extraordinary contributions our Apple II family has made in this field. Not only are Apple II computers removing barriers to life by doing simple things, they're also shattering the more complex barriers of silence and isolation by giving the disabled new ways to communicate.

In 1986, Apple made significant progress in its major international markets, as well. Our largest markets continue to be France, Canada, and Australia.

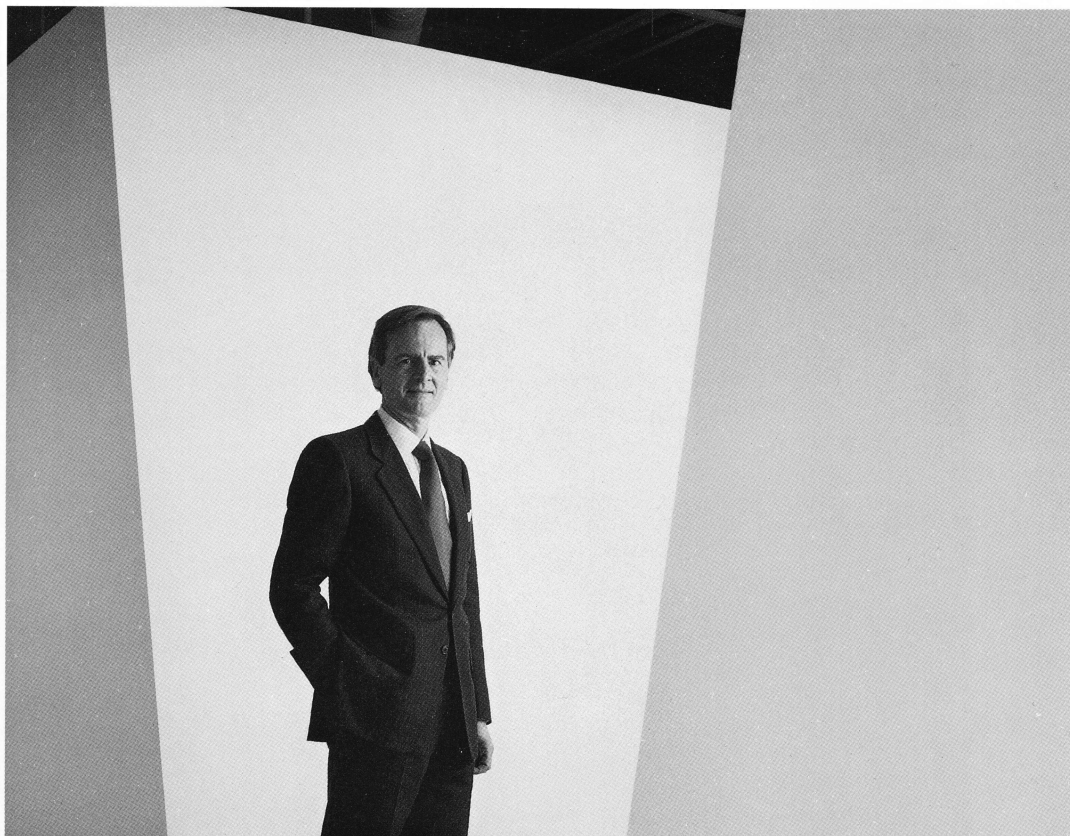
Primarily because the computer revolution is still just beginning in many countries, Apple sales are growing faster internationally than they are in the U.S.

In the United Kingdom, we introduced a new concept called Apple CentresSM that shows great promise. Apple Centres are satellite stores dedicated exclusively to selling Apple desktop solutions. This program provides business dealers with showcase locations in high traffic areas.

On the other side of the globe, we introduced KanjiTalk in Japan. KanjiTalk is systems software that gives Macintosh the three traditional Japanese alphabets, in addition to English, providing Japanese users immediate access to a powerful library of Macintosh software.



Two of Apple's most advanced computers are the Apple IIgs and Macintosh Plus. The engineers who led the development of these products are (from left) Terry Christensen, Fern Bachman, Jay Rickard, Brian Howard (seated), and Adam Grosser.



John Sculley
Chairman, President, and
Chief Executive Officer

What we learned developing KanjiTalk puts us far ahead in developing Macintosh systems software for other languages with pictographic alphabets. Rather than behaving as a multinational corporation, our goal is to become “multilocal”—which means we provide products tailored to our markets, wherever they may be.

International sales now account for 26 percent of Apple’s total revenue, a figure we intend to increase steadily.

To make sure that happens, we’ve appointed Michael H. Spindler to be Senior Vice President, International Sales and Marketing. It’s an appointment that recognizes Mike’s continuing contribution to Apple since he joined the Company as manager of Apple Europe in 1980. Today, he’s responsible for our sales and marketing activities outside the U.S.

1986 was a year of crucial transitions—not the least of which was completing the transition from an Apple organized along product lines to an Apple organized by function.

Obviously, our reorganization worked. But because the kind of Apple we’re building is a hands-on, centralized operation, senior management is involved in a tremendous number of day-to-day decisions. So it soon became clear that another position should be created to handle this operational complexity—that of Chief Operating Officer, working directly with me.

The logical choice for the job was Delbert W. Yocam, formerly Executive Vice President of Product Operations, in charge of advanced technology, product development, manufacturing, distribution, and service.

Del has played a key role in Apple’s growth since he joined the Company in 1979. As we expand our product lines and enter new markets and channels, we’ll require the extraordinary managerial skills Del can bring to bear.

Since Apple technology is a daily part of executive management’s job, we have appointed Lawrence G. Tesler to the newly created position of Vice President, Advanced Technology. With more than 25 years of experience as an engineering manager and researcher, Larry is the ideal person for the job.

Because of our increasing emphasis on strategic sales, we’ve promoted Charles W. Berger to Vice President, Business Development. Chuck joined Apple in 1982 as Treasurer, and brings us valuable experience from his years at Rolm and Memorex.

On the legal front, I’m pleased to report that we have settled our suit against Steve Jobs and his new company.

In last year’s annual report, I told how Apple managed to weather a major computer market slump and a reorganization.

This year, I've tried to give you a picture of the kind of Apple that has emerged, and where it is headed.

Some things haven't changed: Our mission, our vision, and our passion to build great products.

But much else has changed. For the better.

We are no longer dependent solely on one market segment, but enjoy a balance of education, consumer, and business.

We are no longer dependent on one product for the majority of our profits, but enjoy sales balanced between all our product and peripheral families.

We are less dependent on a single selling season—Christmas.

And with international sales at 26 percent of our revenue and growing, we are less dependent on any one part of the world for our long-term success.

Last year, conventional wisdom questioned whether Apple would make it. Did we have the right strategy? Could a better-managed Apple sustain its edge in innovative technology? Could Apple coexist in the business world with MS-DOS? Did Apple really have a future?

I believe Apple's performance in 1986 has provided a resounding answer to each one of those questions.

A handwritten signature in cursive script, reading "John Sculley". The signature is fluid and elegant, with a large initial "J" and a long, sweeping tail.

John Sculley

Chairman, President, and Chief Executive Officer

Apple succeeded
in 1986 because we were
able to change our company
and our products for
the better without changing
our product vision:

We build tools
for the mind to improve
the way people create, work,
learn, and communicate.

We make innovative
computer technology affordable
and accessible.

And we scale
this technology to the needs
of the individual.

Tools for Creating



With advanced color graphics and sound, and our human interface, we build products capable of powerful, flexible, interactive simulations—freeing an individual's ability to imagine and create.

Tools for Working



We design products to make information more useful and understandable for more people in the workplace—with innovative ways to store, retrieve, and analyze data, and then present it to others through professional-quality text and graphics.

Tools for Learning



We build products that make it easier for people of all ages to absorb new information, new ideas, and new concepts. With advanced color graphics and sophisticated high-fidelity sound, we can simulate real-life situations that allow people to explore and experiment. With our human interface, learning to use a computer no longer gets in the way of *learning*.

Tools for Communicating

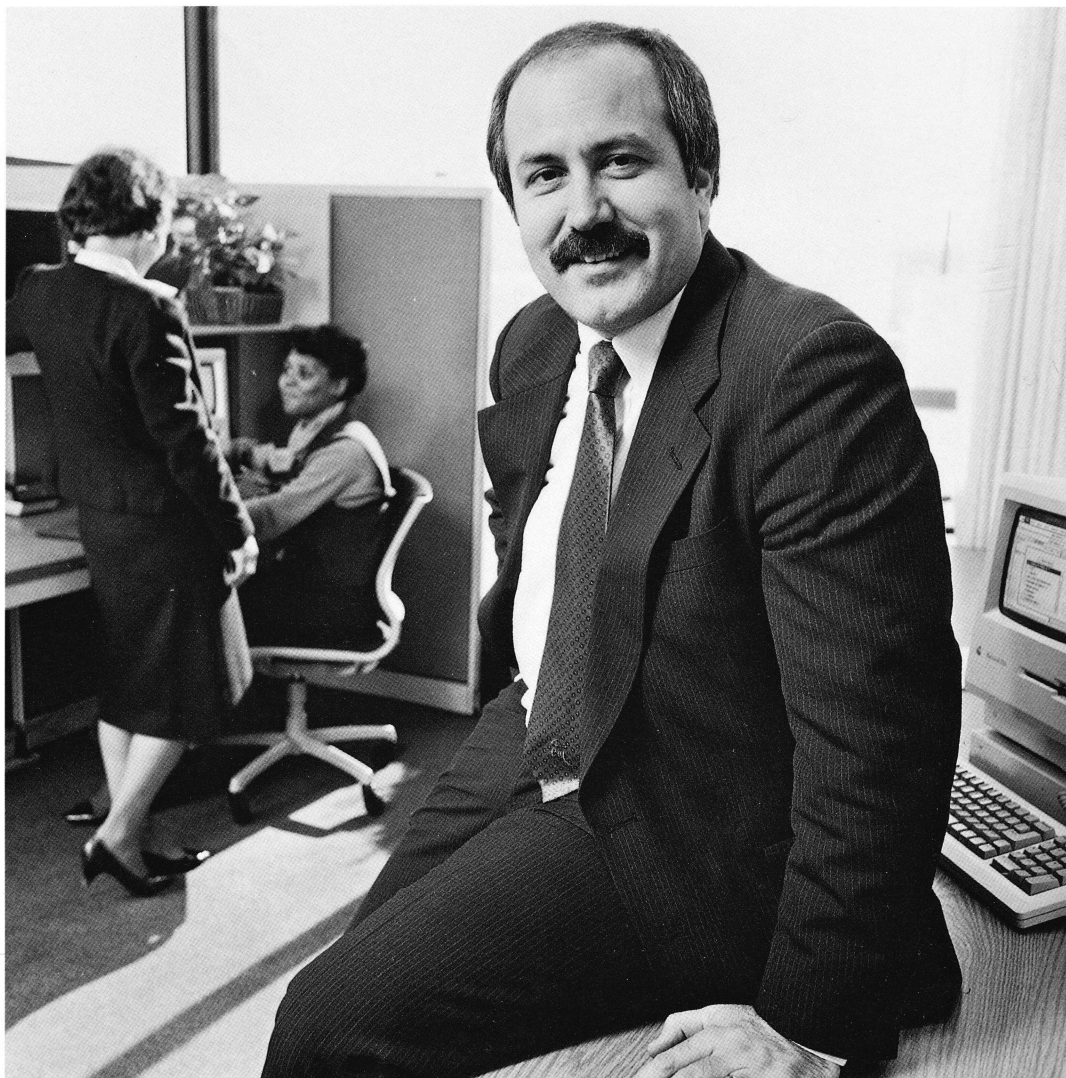


We are working to make our products access and share information easily, regardless of where it resides—in an Apple computer, in another personal computer, in a mini- or mainframe computer. And regardless of where it is needed—in a business, a government office, or a classroom.

Last year, while
some were questioning
Apple's strategy and vision,
millions of others were
validating both.

On the following
pages, we salute a few of
the people who championed
Apple products—people who
made a difference in 1986,
and whose influence
will shape Apple
for years to come.

We've stripped gears in some people's heads with what we can do because of this machine.

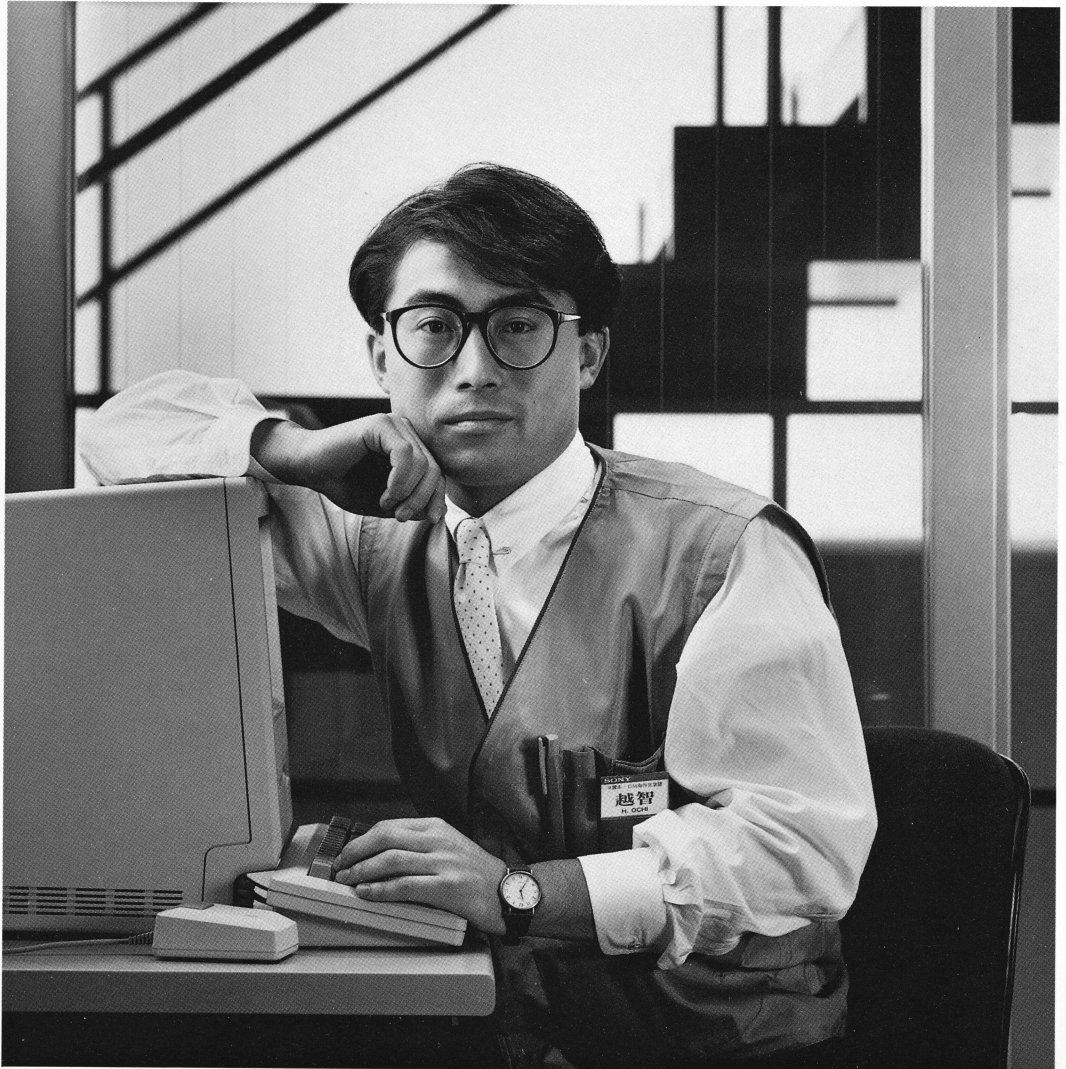


This group that I've got here made a commitment to do whatever it took to do the job right and get it done on time. . . . I didn't want to go to [another personal computer], which could do some of the same things with more difficulty. It would turn my people off and continue to be a millstone around their necks on a daily basis. . . .

Macintosh has turned out to be a real tool rather than an end in itself. We're sold on it. The executives are sold on it.

Greg Factor
Manager, Training and Documentation
McDonnell Douglas Health Systems
St. Louis, Missouri

I think Apple defines what a personal computer should be—
and I would like to capitalize “personal.”



I don't personally have much experience working on a computer. Before I came to Sony, I had never touched a keyboard. Not even a typewriter. But recently I had the chance to try some other computers and found out how difficult it is to make some characters and some signs available on the monitor. I find Mac very easy to use. A lot of people at Sony work on Macs.

I believe Macintosh is an international computer. I would say Sony and Apple share similar values in terms of innovation, vision, and responsiveness to customer needs.

Hajime Ochi
Components Marketing Group
Atsugi Plant
Sony Corporation
Tokyo, Japan

The barriers are not in the technology.



The Apple II has the potential to serve the needs of any individual, but people don't yet know this. . . . A child who has no speech is empowered by having communication through a computer. . . . When those who develop programs that traditionally wouldn't be used by a child with blindness make these programs talk, all of a sudden a whole new world opens up. Everything you talk about that a computer does suddenly works for a disabled individual. These little extra tools open up computing to all people, not just some people.

Jackie Brand
Executive Director
Disabled Children's Computer Group
El Cerrito, California

The bottom line is that the widespread development of thinking skills is of huge importance.

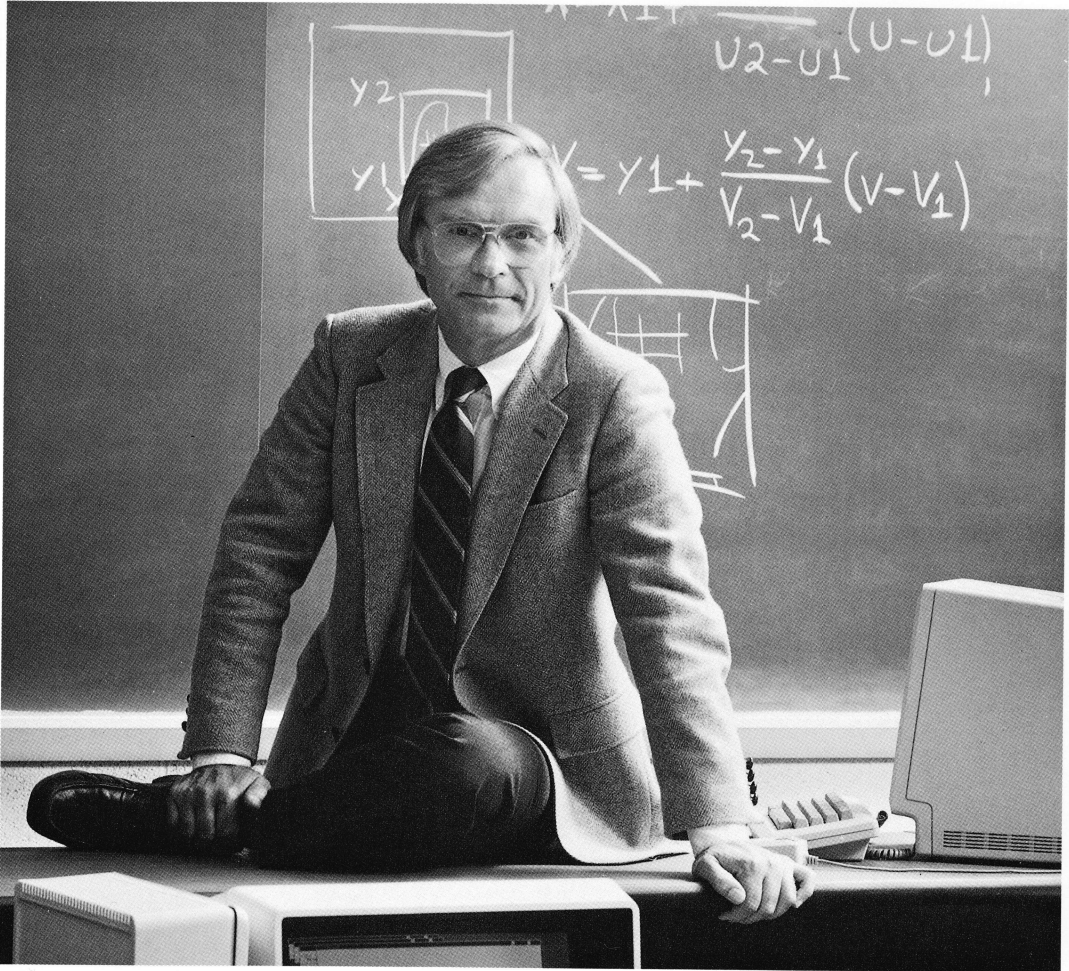


I thought it would be magnificent to show the evolution and development of nature's flying creatures.

The aim of the pterodactyl project was to open people's minds by showing the connections between nature and technology—between, for example, nature's aeronautical designs and the designs of aircraft. A computer that interacted elegantly with humans supported this goal rather nicely. The Macintosh greatly facilitated the simulation of the pterodactyl wing structure—a very demanding, iterative task.

Paul MacCready
President and CEO
AeroVironment, Inc.
Monrovia, California

If you hook three Macintosh computers to a powerful engineering workstation, it's like having four engineering workstations.



We wanted workstations that presented the state-of-the-art user interface and supported high-resolution bit-mapped graphics. They're important in an engineering school, because after mathematics, graphics is an engineer's second language. . . .

We knew we wouldn't be able to afford enough powerful engineering workstations for everybody, so we looked at the other workstations that met our criteria. . . . We saw Macintosh, and we knew it would be a lower-cost, lower-capability machine, but one with full graphics capabilities, and the kind of user interface that we were familiar with.

By itself, Macintosh doesn't have the computational power to do a finite element analysis or a circuit analysis, or design very large-scale integrated chips. . . . [but] the MacApollo project takes an inexpensive Macintosh computer and effectively multiplies the access to Apollo capabilities and software by a factor of 2, 3, or 4, depending on how many Macs you hook up.

Dick Phillips, Ph.D.
*Professor and Former Chairman
Computer Aided Engineering Network
University of Michigan
Ann Arbor, Michigan*

The goal is to have a computer disappear into the classroom.



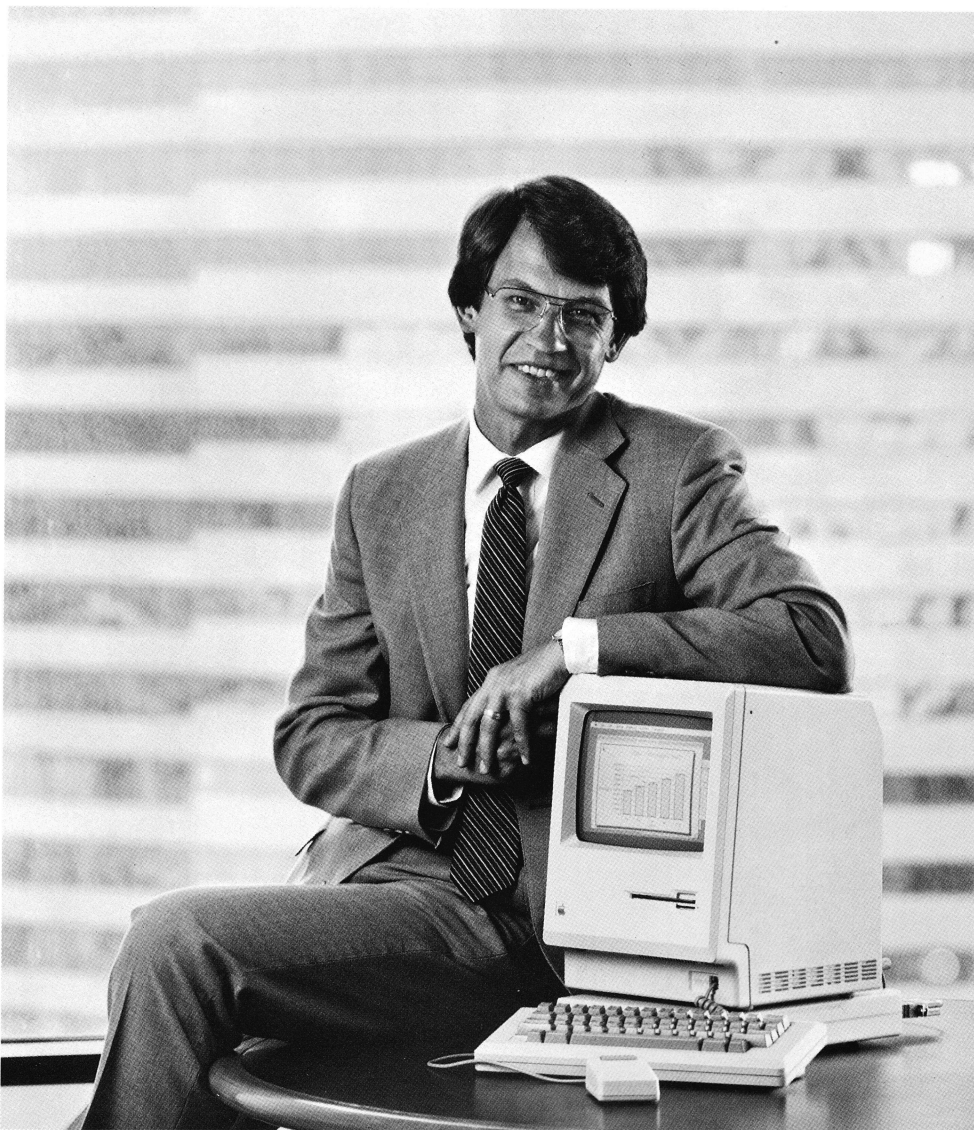
The true power of the computer lies in its ability to enhance communication, data organization, and information processing.

We ought to be using software that is highly interactive and that provides students with informational as well as judgmental feedback: graphing tools, tools for analyzing word problems, models of mathematical reasoning, and simulations of interactive systems.

We have only begun to identify ways in which the true power of the computer can be harnessed to develop the educational potential, both cognitively and affectively, of students in the primary and secondary grades.

Florence Mann, Ph.D.
Director
Bronx Technical Assistance Center
Office of Technology
New York City Board of Education

The reason we got Macintosh had to do with two very basic concepts: economics and economics.



I run a business inside a business. We have around 2,100 Macintosh computers—probably the highest ratio of personal computers to staff of any company our size. Our commitment to technology has one simple goal: to provide the highest possible service at the lowest possible cost.

The typical American wisdom is that you can't improve service without increasing costs. However, in Technology Services from 1985 to 1986, service was up and total operating costs were down. And they'll go down again from 1986 to 1987—that's not some accounting machination, that's net, net.

Tim Turnpaugh
Senior Vice President
Manager of Technology Services
Seafirst Bank
Seattle, Washington

This is my eighth year in business. I started when I was 11 years old.



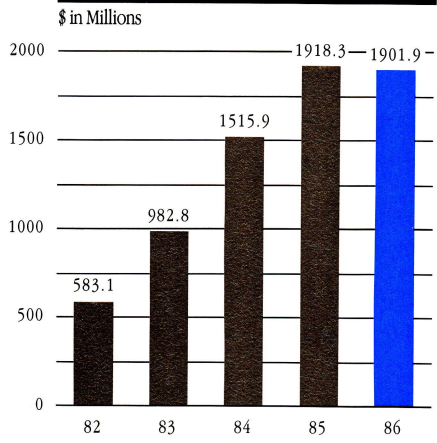
I bought my Apple IIc with profits from the 18,000 candy bars I sold to my high school for a candy bar drive. Then I got a \$75,000 loan from a local bank. Now we have a staff of about seven people, and we're going after corporate accounts.

The IIc enabled me to change my candy making from a hobby into a business. My entire business is run through the Apple IIc. I couldn't live without one.

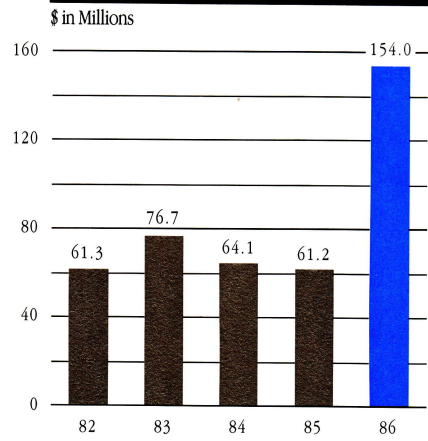
Kim Merritt
President
Kim's Khocolate
Cumberland, Maryland

Financial Results

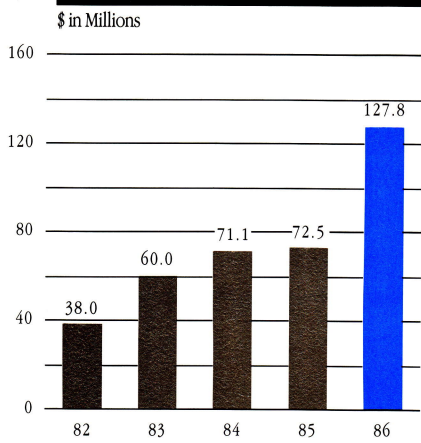
Net Sales



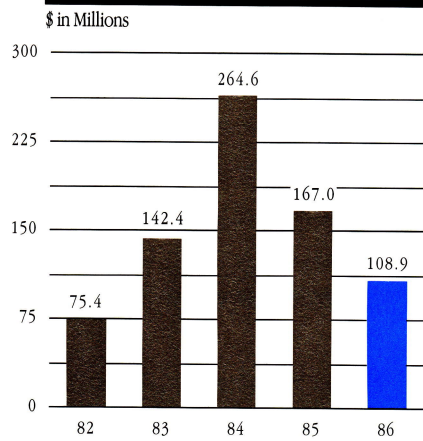
Net Income



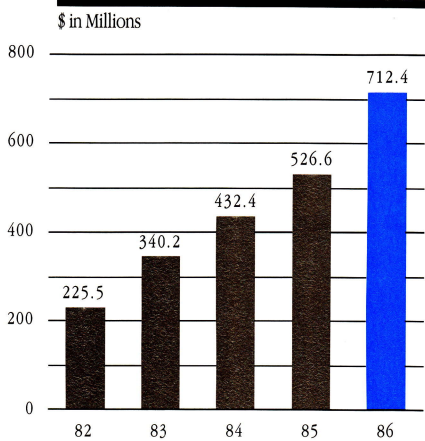
Research and Development



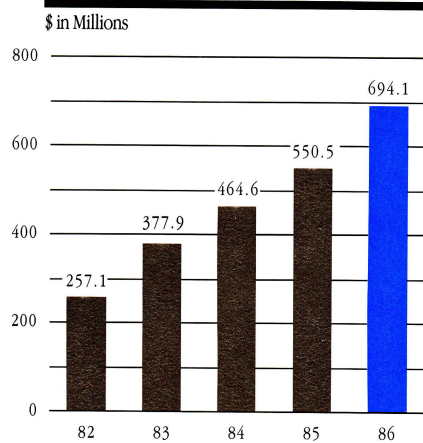
Net Inventory



Working Capital



Shareholders' Equity



Selected Financial Information

Annual					
(In thousands, except per share amounts)					
	1986	1985*	1984	1983	1982
Net sales	\$1,901,898	\$1,918,280	\$1,515,876	\$982,769	\$583,061
Net income	\$ 153,963	\$ 61,223	\$ 64,055	\$ 76,714	\$ 61,306
Earnings per common and common equivalent share	\$ 2.39	\$.99	\$ 1.05	\$ 1.28	\$ 1.06
Common and common equivalent shares used in the calculations of earnings per share	64,315	61,895	60,887	59,867	57,798
Cash and temporary cash investments	\$ 576,215	\$ 337,013	\$ 114,888	\$143,284	\$153,056
Total assets	\$1,160,128	\$ 936,177	\$ 788,786	\$556,579	\$357,787
Noncurrent obligations under capital leases	\$ —	\$ —	\$ —	\$ 1,308	\$ 2,052

Apple has not paid any cash dividends on its common stock. The present policy is to reinvest earnings to finance future growth.

Quarterly (Unaudited)

(In thousands, except per share amounts)					
1986	Fourth Quarter*	Third Quarter*	Second Quarter	First Quarter	
Net sales	\$ 510,786	\$ 448,279	\$ 408,943	\$ 533,890	
Gross margin	\$ 272,463	\$ 236,032	\$ 231,360	\$ 270,931	
Net income	\$ 32,893	\$ 32,333	\$ 31,812	\$ 56,925	
Earnings per common and common equivalent share	\$.51	\$.49	\$.50	\$.91	
Price range per common share	\$37 ³ / ₄ -\$30 ¹ / ₂	\$38 ⁷ / ₈ -\$26 ³ / ₄	\$ 28 ¹ / ₄ -\$22	\$ 22 ³ / ₈ -\$15	
1985					
Net sales	\$ 409,709	\$ 374,930	\$ 435,344	\$ 698,297	
Gross margin	\$ 188,039	\$ 154,467	\$ 175,415	\$ 282,495	
Net income (loss)	\$ 22,357	\$ (17,210)	\$ 9,977	\$ 46,099	
Earnings (loss) per common and common equivalent share	\$.36	\$ (.28)	\$.16	\$.75	
Price range per common share	\$18 ¹ / ₈ -\$14 ¹ / ₂	\$22 ⁷ / ₈ -\$14 ³ / ₄	\$ 30 ⁵ / ₈ -\$21 ¹ / ₂	\$ 28 ⁵ / ₈ -\$21 ⁷ / ₈	

The price range per common share represents the highest and lowest closing prices for Apple's common stock in the NASDAQ National Market System during each quarter.

At September 26, 1986, there were approximately 35,000 shareholders of record.

*The third and fourth quarters of fiscal 1985 include \$40 million and \$(3 million), respectively, charged (credited) to income before income taxes related to the consolidation of the Company's operations, as discussed in the notes to the consolidated financial statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto. All information is based on Apple's *fiscal* calendar.

Results of Operations

1986 Compared with 1985

This past year was a transition year for Apple.

As 1986 began, many companies, including Apple, were still experiencing the effects of an industry slowdown. In light of this, the first item on the Company's agenda called for controlling costs and improving margins. At the same time, Apple was planning its reemergence as a growth company by significantly increasing investment in new product development. In large measure, as suggested in the discussion that follows, the Company's efforts in this regard were successful. In 1986, Apple doubled previous record net income, posting earnings of \$154 million or \$2.39 per share, despite no growth in revenues.

Net sales in 1986 were \$1,902 million, a slight decrease from \$1,918 million in 1985. Bolstered by the introductions of the Macintosh 512K Enhanced, the Macintosh Plus, and the LaserWriter Plus during the year, together with momentum provided by renewed interest from third-party hardware and software developers, revenues from the sale of Macintosh family products in 1986 eclipsed Apple II family products for the first time. In general, increased unit sales volume of higher-end Macintosh computers, and market acceptance of certain peripherals introduced in late 1985 and 1986 were offset by the effects of reduced unit sales volume of lower-end Apple II computers and certain price reductions to meet competitive pressures. The Apple IIgs, which was announced in the fourth quarter of 1986, did not ship in significant volumes.

Gross margin was 53% of sales in 1986, representing an increase of 11 percentage points from the 42% registered in 1985. Much of this increase was attributable to economies arising from the June 1985 consolidation of operations, alluded to above. Also, improved financial controls that were implemented subsequently permitted reductions in average inventories and, therefore, reductions in related financial exposures. For example, inventory scrap and obsolescence expenses decreased significantly from 1985 to 1986. Other manufacturing efficiencies resulted from the Company's continuing keen interest in automated assembly techniques and improved yields. Changes in sales mix also contributed to the improvement in gross margin performance in 1986. Apple's ability to maintain margins at 1986 levels in the future may be affected by increased competition, changes in the cost of certain materials, and start-up inefficiencies associated with expected new product introductions.

Research and development expenses in 1986 increased to \$128 million or 6.7% of sales, from \$73 million or 3.8% of sales in 1985. The sharp rise in spending resulted from intensified system development efforts in 1986, including significant additions to Apple's engineering staff, increases in prototype materials and tooling, and the purchase of other equipment and proprietary design software to shorten product development cycles.

Marketing and distribution expenses were \$477 million or 25% of sales in 1986, very closely approximating 1985 expenditure levels in the aggregate. Relative to the preceding year, in 1986 Apple chose to invest proportionately more in various focused sales and marketing programs and proportionately less in advertising and merchandising, notwithstanding significant fourth quarter advertising increases related to the Apple IIgs rollout and a new television campaign. Distribution expenses were comparable in 1985 and 1986.

General and administrative expenses increased to \$133 million or 7.0% of sales in 1986, from \$110 million or 5.7% of sales in 1985. In 1986, Apple provided proportionately more of each sales dollar for bad debt expenses, primarily in recognition of continuing difficult business conditions in the U.S. retail channel, but also due to certain changes in strategic direction that culminated in the consolidation of the U.S. dealer network and the restructuring of certain foreign selling arrangements during the year. In addition, continued investment in the Company's internal data processing and communications capabilities contributed to the increase in general and administrative expenditures from 1985.

Interest and other income, net, was \$36 million in 1986, more than double the \$17 million from 1985. The improvement in 1986 resulted principally from higher interest income associated with the increase in average short-term cash investments. Favorable currency fluctuations, reflecting moderation in the strength of the dollar during 1986, further contributed to the increase.

The effective income tax rate was 50% in 1986, representing a slight increase from 49% in 1985. In part, the increase arose from Apple's receiving proportionately less benefit from certain tax credits due to the sharp rise in pretax earnings in 1986.

The impact of inflation on Apple's financial position and results of operations has been minimal.

1985 Compared with 1984

Although the Company began 1985 with record sales, the industry slowdown quickly affected Apple. As a result, 1985 earnings were reduced by a pretax charge of \$37 million—management's estimate of the costs associated with the major organizational and operational restructuring of the Company in June 1985.

Net sales in 1985 were \$1,918 million, an increase of \$402 million or 27% over 1984. The Company's sales growth was generally attributable to increased unit volume. In 1985, Apple responded to sluggish business conditions by implementing sales incentive programs that offered price reductions on various bundled systems. Apple IIe sales increased slightly in 1985. The Macintosh and Apple IIc, which were introduced in the second and third quarters, respectively, of 1984, had a significant impact on 1985 sales. In the fourth quarter of 1985, the Company introduced a 20-megabyte hard disk for the Macintosh, and eight new products designed to technologically enhance the Apple II. These new products did not significantly affect 1985 sales.

Gross margin was 42% of sales in 1985, unchanged from 1984. In general, margin improvements afforded by manufacturing economies, including falling semiconductor prices, were offset by the aforementioned price reductions and greater provisions for excess and obsolete inventories. In addition, 1985 sales to the education market, which generally result in lower gross margins than sales through Apple's other distribution channels, increased as a percentage of total Company sales. Gross margin was 46% in the fourth quarter of 1985. The improvement was attributable to the consolidation of manufacturing operations, higher production levels, and lower material costs.

Research and development expenses in 1985 were \$73 million, representing a modest increase from \$71 million in 1984. As a percentage of sales, research and development expenditures decreased 0.9 percentage points to 3.8%. The decline in spending as a percentage of sales in part reflects significant expenses incurred in the first half of 1984 related to the Macintosh and Apple IIc computers, which were then under development. In addition, 1985 spending was affected by the cancelation of certain accessory product projects and the temporary interruption of work on other projects due to the significant operational changes then taking place within the Company.

Marketing and distribution expenses decreased to 25% of sales, compared with 26% in 1984. The decline in spending as a percentage of sales resulted principally from proportionately reduced spending for advertising, offset in part by increased payments to dealers for installation and training on Apple's direct sales to educational institutions. In the fourth quarter of 1985, Apple announced its intention to distribute the Macintosh personal computer almost entirely through its network of authorized dealers and to significantly improve relations with outside add-on hardware and software suppliers. These moves, designed to increase the dealer support and versatility of Apple products, did not significantly affect 1985 marketing and distribution expenses.

General and administrative expenses as a percentage of sales increased 0.3 percentage points to 5.7% in 1985.

Interest and other income, net, was \$17 million in 1985, a decrease from \$23 million in 1984. Interest income in 1985 was comparable to that in 1984, as the impact of higher average short-term cash investments was generally offset by declining interest rates. A litigation settlement and the sale of certain technical data contributed to other income in 1984.

The effective income tax rate increased to 49% in 1985, from 41% in 1984. This resulted principally from the effect of the 1984 reversal of deferred taxes previously provided on the accumulated earnings of the Company's Domestic International Sales Corporation in accordance with the Tax Reform Act of 1984.

Liquidity and Capital Resources

Apple relies primarily on the results of its operations to generate the cash necessary to meet its liquidity needs. In addition, Apple's liquidity is enhanced by the proceeds from the sale of common stock under the Company's stock option and employee stock purchase plans, and related tax benefits. The tax benefit recognized upon the exercise of nonqualified stock options arises because Apple receives a compensation deduction for tax reporting purposes for the difference between the option exercise prices and the fair market value of the shares at the time of exercise. In 1986 and 1985, Apple realized similar tax benefits for certain participant dispositions of shares acquired through the employee stock purchase plan.

1986 Compared with 1985

In 1986, Apple improved its strong financial condition while continuing to make significant investments in research and development and in advanced manufacturing technologies. Working capital increased \$186 million or 35% from 1985. Cash and temporary cash investments increased \$239 million or 71%, notwithstanding Apple's utilizing \$55 million of cash in the fourth quarter of 1986 to repurchase previously outstanding common stock. Investment in new property, plant, and equipment increased 23% from 1985 to a record \$67 million.

The major sources of liquidity in 1986 were \$262 million from operations and \$46 million from the sale of common stock to employees under Apple's stock option and employee stock purchase plans, including \$9 million in related tax benefits, representing increases of \$125 million, \$22 million, and \$3 million, respectively, from 1985.

Emphasis on inventory control in 1986 allowed the Company to significantly reduce inventory levels and improve inventory turnover. Net inventories decreased 35% to \$109 million, as inventory turnover increased to 6.5 in 1986, from 5.2 in 1985. In the fourth quarter of 1986, inventory turnover reached 9.1. Patterns in accounts receivable collections were very similar from 1985 to 1986. Thus, the increase in accounts receivable from \$220 million to \$263 million generally reflects higher fourth quarter sales levels in 1986.

At September 26, 1986, unused sources of liquidity consisted primarily of \$576 million in cash and temporary cash investments. The Company's capital resource commitments at the end of 1986 consisted principally of obligations under operating lease agreements.

1985 Compared with 1984

In 1985, working capital increased \$94 million or 22% from 1984. Cash and temporary cash investments increased \$222 million or 193% over this same period.

Apple's traditional sources of funds—operations and sales of common stock to employees—provided working capital of \$161 million in 1985, an increase of \$15 million from \$146 million in 1984. In 1985, disposals of property, plant, and equipment with a net book value of approximately \$13 million resulted principally from the consolidation of operations. In 1984, there were no significant disposals of property, plant, and equipment.

Apple assumed a cautious posture relative to receivables and inventory management in 1985, as the industry entered a period of slow or no growth. Net accounts receivable decreased 15% to \$220 million in 1985, predominantly from reduced billings. Net inventories decreased 37% to \$167 million, as inventory turnover improved to 5.2 in 1985, from 4.3 in 1984. The decrease in inventories in 1985 resulted from aggressive inventory management as well as a conservative policy with respect to manufacturing build, in light of the market conditions discussed above. Further, in 1984 the Company had increased inventory to satisfy anticipated heavy holiday season demand and an unusually large back order of Apple IIe systems for education.

Consolidated Statements of Income

Three years ended September 26, 1986

(In thousands, except per share amounts)

	1986	1985	1984
Net sales	<u>\$1,901,898</u>	<u>\$1,918,280</u>	<u>\$1,515,876</u>
Costs and expenses:			
Cost of sales	891,112	1,117,864	878,586
Research and development	127,758	72,526	71,136
Marketing and distribution	476,685	478,079	398,463
General and administrative	<u>132,812</u>	<u>110,077</u>	<u>81,840</u>
	<u>1,628,367</u>	<u>1,778,546</u>	<u>1,430,025</u>
Operating income before unusual item	273,531	139,734	85,851
Unusual item—provision for consolidation of operations	—	(36,966)	—
Interest and other income, net	<u>36,187</u>	<u>17,277</u>	<u>23,334</u>
Income before income taxes	309,718	120,045	109,185
Provision for income taxes	<u>155,755</u>	<u>58,822</u>	<u>45,130</u>
Net income	<u>\$ 153,963</u>	<u>\$ 61,223</u>	<u>\$ 64,055</u>
Earnings per common and common equivalent share	<u>\$ 2.39</u>	<u>\$.99</u>	<u>\$ 1.05</u>
Common and common equivalent shares used in the calculations of earnings per share	<u>64,315</u>	<u>61,895</u>	<u>60,887</u>

See accompanying notes.

Consolidated Balance Sheets

September 26, 1986 and September 27, 1985

(Dollars in thousands)

Assets	1986	1985
Current assets:		
Cash and temporary cash investments	\$ 576,215	\$337,013
Accounts receivable, net of allowance for doubtful accounts of \$21,792 (\$16,209 in 1985)	263,126	220,157
Inventories	108,680	166,951
Prepaid income taxes	53,029	70,375
Other current assets	39,884	27,569
Total current assets	<u>1,040,934</u>	<u>822,065</u>
Property, plant, and equipment:		
Land and buildings	25,660	23,621
Machinery and equipment	103,963	78,725
Office furniture and equipment	44,237	38,551
Leasehold improvements	48,179	34,738
	222,039	175,635
Accumulated depreciation and amortization	<u>(114,724)</u>	<u>(85,189)</u>
Net property, plant, and equipment	<u>107,315</u>	<u>90,446</u>
Other assets		
	11,879	23,666
	<u>\$1,160,128</u>	<u>\$936,177</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 118,053	\$ 74,744
Accrued compensation and employee benefits	37,238	25,595
Income taxes payable	14,652	27,800
Accrued marketing and distribution	83,577	75,934
Accrued cost of consolidation of operations	3,735	20,173
Other current liabilities	71,280	71,179
Total current liabilities	<u>328,535</u>	<u>295,425</u>
Deferred income taxes	137,506	90,265
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 160,000,000 shares authorized; 62,627,613 shares issued and outstanding in 1986 (61,849,802 shares in 1985)	227,075	234,625
Retained earnings	474,287	320,324
Accumulated translation adjustment	(966)	414
	700,396	555,363
Notes receivable from shareholders	<u>(6,309)</u>	<u>(4,876)</u>
Total shareholders' equity	<u>694,087</u>	<u>550,487</u>
	<u>\$1,160,128</u>	<u>\$936,177</u>

See accompanying notes.

Consolidated Statements of Shareholders' Equity

(In thousands)

	Common Stock		Retained Earnings	Accumulated Translation Adjustment	Notes Receivable from Shareholders	Total Shareholders' Equity
	Shares	Amount				
Balance at September 30, 1983	59,198	\$183,715	\$195,046	\$ —	\$ (860)	\$377,901
Sale of common stock under stock option plans, and related tax benefits	1,091	19,356	—	—	(2,342)	17,014
Sale of common stock under employee stock purchase plan	246	5,877	—	—	—	5,877
Repayment of notes receivable from shareholders	—	—	—	—	351	351
Accumulated translation adjustment	—	—	—	(633)	—	(633)
Net income	—	—	64,055	—	—	64,055
Balance at September 28, 1984	60,535	208,948	259,101	(633)	(2,851)	464,565
Sale of common stock under stock option plans, and related tax benefits	1,024	19,748	—	—	(2,190)	17,558
Sale of common stock under employee stock purchase plan, and related tax benefits	291	5,929	—	—	—	5,929
Repayment of notes receivable from shareholders	—	—	—	—	165	165
Accumulated translation adjustment	—	—	—	1,047	—	1,047
Net income	—	—	61,223	—	—	61,223
Balance at September 27, 1985	61,850	234,625	320,324	414	(4,876)	550,487
Sale of common stock under stock option plans, and related tax benefits	2,118	40,478	—	—	(3,648)	36,830
Sale of common stock under employee stock purchase plan, and related tax benefits	370	6,477	—	—	—	6,477
Purchase of outstanding common stock for retirement	(1,710)	(54,505)	—	—	—	(54,505)
Repayment of notes receivable from shareholders	—	—	—	—	2,215	2,215
Accumulated translation adjustment	—	—	—	(1,380)	—	(1,380)
Net income	—	—	153,963	—	—	153,963
Balance at September 26, 1986	62,628	\$227,075	\$474,287	\$ (966)	\$(6,309)	\$694,087

See accompanying notes.

Consolidated Statements of Changes in Financial Position

Three years ended September 26, 1986

(in thousands)

	1986	1985	1984
Working capital was provided by:			
Operations:			
Net income	\$153,963	\$ 61,223	\$ 64,055
Charges to operations not affecting working capital:			
Depreciation and amortization	51,075	41,841	37,963
Deferred income taxes (noncurrent)	47,241	21,228	20,453
Net book value of property, plant, and equipment retirements	9,488	12,744	—
Total working capital provided by operations	<u>261,767</u>	<u>137,036</u>	<u>122,471</u>
Increases in common stock and related tax benefits, net of changes in notes receivable from shareholders			
	45,522	23,652	23,242
Total working capital provided	<u>307,289</u>	<u>160,688</u>	<u>145,713</u>
Working capital was applied to:			
Purchase of property, plant, and equipment (net of retirements in 1984)	66,629	54,064	39,614
Purchase of outstanding common stock for retirement	54,505	—	—
Other	396	12,351	13,939
Total working capital applied	<u>121,530</u>	<u>66,415</u>	<u>53,553</u>
Increase in working capital	<u>\$185,759</u>	<u>\$ 94,273</u>	<u>\$ 92,160</u>
Increase (decrease) in working capital by component:			
Cash and temporary cash investments	\$239,202	\$222,125	\$(28,396)
Accounts receivable	42,969	(38,081)	121,818
Inventories	(58,271)	(97,668)	122,162
Prepaid income taxes	(17,346)	43,624	(1,198)
Other current assets	12,315	4,514	4,172
Accounts payable	(43,309)	34,294	(56,337)
Accrued compensation and employee benefits	(11,643)	(5,139)	(4,686)
Income taxes payable	13,148	(16,532)	(11,268)
Accrued marketing and distribution	(7,643)	(25,296)	(29,087)
Accrued cost of consolidation of operations	16,438	(20,173)	—
Other current liabilities	(101)	(7,395)	(25,020)
Increase in working capital	<u>\$185,759</u>	<u>\$ 94,273</u>	<u>\$ 92,160</u>

See accompanying notes.

Notes to Consolidated Financial Statements

Summary of Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of Apple and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Apple's fiscal year-end is the last Friday in September.

Inventories

Inventories are stated at the lower of cost or market. Cost is computed using currently adjusted standards that approximate actual cost on a first-in, first-out basis. Market is based on estimated net realizable value.

Property, Plant, and Equipment

Property, plant, and equipment is stated at cost. Depreciation and amortization is computed principally by use of declining balance methods over the estimated useful lives of the assets.

Service Parts

Service parts totaling \$5 million in 1986 and \$16 million in 1985 are included in other assets. Service parts are stated at cost less accumulated amortization, which is computed on a straight-line basis over 36 months.

Floor Planning Credit Program

Certain expenses associated with Apple's floor planning credit program, previously deducted from interest and other income, have been reclassified as marketing and distribution expenses in 1986. The 1985 and 1984 consolidated financial statements have been reclassified to conform with the current presentation.

Income Taxes

The provision for income taxes takes into consideration all income and expenses for the current year, regardless of when such items are recognized for tax reporting purposes. Furthermore, federal and state income taxes are provided on earnings of foreign subsidiaries each year, assuming the eventual remittance of such earnings back to the parent company. Investment tax credits are recognized on the flow-through method as a reduction of income tax expense in the year the assets are placed in service.

Foreign Currency Translation

Gains and losses resulting from foreign currency translation are accumulated as a separate component of shareholders' equity until the foreign entity is sold or liquidated. Gains and losses resulting from foreign currency transactions are not material and are included in the statement of income for each of the three years presented.

Earnings per Share

Earnings per share are computed using the weighted average number of common shares and dilutive common equivalent shares outstanding during the period.

Consolidation of Operations

In June 1985, the Company reorganized along functional lines instead of product lines and reduced the number of manufacturing facilities worldwide from six to three. Apple recorded \$37 million of plant and equipment write-downs, facility lease cancellations, employee compensation, and other unusual charges related to the consolidation of operations.

Inventories

Inventories consist of the following:

	(In thousands)	
	1986	1985
Raw materials and purchased parts	\$ 14,778	\$ 30,897
Work in process (including material held by subcontractors)	10,578	11,569
Finished goods	<u>83,324</u>	<u>124,485</u>
	<u>\$108,680</u>	<u>\$166,951</u>

Income Taxes

The provision for income taxes consists of the following:

	(In thousands)		
	1986	1985	1984
Federal:			
Current	\$ 63,925	\$62,110	\$27,682
Deferred (prepaid)	<u>60,181</u>	<u>(18,755)</u>	<u>6,537</u>
	<u>124,106</u>	<u>43,355</u>	<u>34,219</u>
State:			
Current	17,271	9,899	6,835
Deferred (prepaid)	<u>5,613</u>	<u>(2,109)</u>	<u>671</u>
	<u>22,884</u>	<u>7,790</u>	<u>7,506</u>
Foreign:			
Current	9,972	9,209	4,850
Deferred (prepaid)	<u>(1,207)</u>	<u>(1,532)</u>	<u>(1,445)</u>
	<u>8,765</u>	<u>7,677</u>	<u>3,405</u>
Provision for income taxes	<u>\$155,755</u>	<u>\$58,822</u>	<u>\$45,130</u>

The federal provision for income taxes reflects U.S. income tax law in effect on September 26, 1986. The effect of the Tax Reform Act of 1986 on the consolidated financial statements would be immaterial. The foreign provision for income taxes is based on foreign pretax earnings of approximately \$136 million in 1986, \$59 million in 1985, and \$63 million in 1984.

Deferred (prepaid) income taxes result from timing differences between years in the recognition of certain revenue and expense items for financial and tax reporting purposes. The sources of timing differences and the related tax effects are as follows:

	(In thousands)		
	1986	1985	1984
Warranty, bad debt, and other expenses not currently deductible	\$(3,367)	\$(26,846)	\$(5,225)
Income reported on installment method for tax reporting purposes	5,365	4,315	4,754
Inventory valuation differences	20,497	(15,536)	(14,333)
Income of Domestic International Sales Corporation (DISC)	269	927	(4,107)
Income of foreign subsidiaries not taxable in current year	46,390	20,980	26,014
Financial statement depreciation not currently deductible	(3,385)	(5,317)	(3,540)
State income taxes deductible in succeeding years	(123)	(6,134)	—
Other individually immaterial items	<u>(1,059)</u>	<u>5,215</u>	<u>2,200</u>
Total deferred (prepaid) taxes	<u>\$64,587</u>	<u>\$(22,396)</u>	<u>\$ 5,763</u>

A reconciliation of the total provision for income taxes with the amount computed by applying the statutory federal income tax rate (46%) is as follows:

	(In thousands)		
	1986	1985	1984
Computed expected tax (in 1984, net of surtax exemption)	\$142,470	\$55,221	\$50,206
State taxes, net of federal benefit	12,357	4,207	4,054
Tax-exempt DISC and FSC income	(780)	(1,400)	(4,900)
Investment tax credits	(1,700)	(950)	(1,350)
Research and development tax credit	(660)	(460)	(2,350)
Other	4,068	2,204	(530)
Provision for income taxes	<u>\$155,755</u>	<u>\$58,822</u>	<u>\$45,130</u>
Effective tax rate	<u>50.3%</u>	<u>49.0%</u>	<u>41.3%</u>

Included in the 1984 tax-exempt DISC income is \$4 million attributable to earnings accumulated in prior years. The Company established a Foreign Sales Corporation (FSC) effective January 1, 1985.

Leases

Apple leases various facilities and equipment under noncancelable lease arrangements. The major facilities leases are for terms of five to ten years and generally provide renewal options of up to ten additional years.

Future minimum lease payments under all noncancelable operating leases as of September 26, 1986, are as follows:

	(In thousands)
1987	\$ 36,711
1988	29,785
1989	21,683
1990	13,986
1991	10,313
Later years	<u>13,882</u>
Total minimum lease payments	<u>\$126,360</u>

Rent expense under all operating leases was \$35 million, \$23 million, and \$21 million in 1986, 1985, and 1984, respectively.

Preferred Stock

Five million shares of preferred stock have been authorized for issuance in one or more series. The Board of Directors is authorized to fix the number and designation of any such series and to determine the rights, preferences, privileges, and restrictions granted to or imposed upon any such series.

Common Stock

Stock Repurchase Program

During 1986, the Board of Directors authorized management to purchase and retire up to 5 million shares of Apple's common stock from time to time in the open market or in negotiated transactions at prevailing market prices. As of September 26, 1986, the Company had purchased and retired 1.7 million shares under this program at an average price of \$31.87 per share.

Stock Option Plans

Apple has stock option plans under which officers, directors, employees, and contractors may be granted options to purchase shares of Apple's common stock at the fair market value on the date of grant. The options become exercisable over varying periods and expire six years to ten years and one month after the grant date. The 1981 Stock Option Plan permits the granting of both incentive stock options and nonqualified stock options, although it is the current policy of the Stock Option Committee to grant only nonqualified options. Proceeds from the exercise of stock options, including income tax benefits of \$9 million, \$6 million, and \$7 million in 1986, 1985, and 1984, respectively, have been added to shareholders' equity.

Summarized information regarding the stock option plans at September 26, 1986, is as follows:

	(In thousands, except per share amounts)	
	Number of Shares	Price per Share
Outstanding	7,722	\$1.31-\$43.06
Exercisable	<u>1,880</u>	<u>\$1.31-\$43.06</u>
Reserved for issuance	12,767	
Available for future grant	<u>5,045</u>	

Included in the number of shares reserved for issuance are 4 million shares that were approved by the Board of Directors in November 1986 and are subject to shareholder approval.

Employee Stock Purchase Plan

Apple has an employee stock purchase plan under which 2 million shares of common stock were reserved for issuance. This plan provides that substantially all employees may purchase stock at 85% of its fair market value at certain specified dates. Purchases are limited to 10% of an employee's compensation.

Litigation

In February and March 1984, six class action complaints were filed against Apple and fourteen of its officers and directors, alleging violations of federal and state securities laws, including allegations of fraud and insider trading based on the Company's alleged failure to make certain disclosures of material facts during the period from November 12, 1982, to September 23, 1983. The Company believes the suits are without merit and continues to vigorously litigate the claims asserted in these actions. Discovery is ongoing, and trial in the federal actions is scheduled to start February 16, 1987. Apple maintains directors' and officers' insurance that it believes should defray a portion of any liability and the costs of defense. Although the amount of relief sought by the plaintiffs is unspecified, the litigation will, in the opinion of management, result in no material loss to the Company.

Industry Segment and Geographic Information

Apple operates in one principal industry segment: the design, manufacture, sale, and servicing of personal computers and related software and peripheral products. Apple's products are sold primarily to the business, education, and home markets. The principal methods of distribution are the independent retail dealer, national retail accounts, and direct sales.

Apple's foreign operations consist of manufacturing facilities in Ireland and Singapore; distribution facilities in Europe, Canada, and Australia; and sales and procurement offices in Japan. After consolidating adjustments, total assets and liabilities of foreign subsidiaries are as follows:

	(In thousands)		
	1986	1985	1984
Total assets	\$519,456	\$325,708	\$254,924
Total liabilities	\$ 69,003	\$ 61,248	\$ 87,899

Geographic financial information is as follows:

	(In thousands)		
	1986	1985	1984
Net sales to unaffiliated customers in:			
United States	\$1,411,812	\$1,490,396	\$1,187,839
Europe	298,843	247,609	192,187
Other	191,243	180,275	135,850
Total net sales	<u>\$1,901,898</u>	<u>\$1,918,280</u>	<u>\$1,515,876</u>
Transfers between geographic areas (eliminated in consolidation):			
United States	\$ 204,454	\$ 220,653	\$ 142,059
Europe	12,709	31,041	20,533
Other	187,834	269,265	210,885
Total transfers	<u>\$ 404,997</u>	<u>\$ 520,959</u>	<u>\$ 373,477</u>
Operating income:			
United States	\$ 161,192	\$ 57,538	\$ 43,503
Europe	47,814	2,712	14,559
Other	58,241	53,976	32,791
Eliminations	6,284	(11,458)	(5,002)
Unallocated	<u>36,187</u>	<u>17,277</u>	<u>23,334</u>
Income before income taxes	<u>\$ 309,718</u>	<u>\$ 120,045</u>	<u>\$ 109,185</u>
Identifiable assets:			
United States	\$ 427,746	\$ 469,654	\$ 534,251
Europe	108,232	85,098	104,081
Other	55,717	66,387	46,385
Eliminations	(7,782)	(21,975)	(10,819)
Corporate assets	<u>576,215</u>	<u>337,013</u>	<u>114,888</u>
Total assets	<u>\$1,160,128</u>	<u>\$ 936,177</u>	<u>\$ 788,786</u>

Transfers between geographic areas are recorded at amounts generally above cost and in accordance with the rules and regulations of the respective governing tax authorities. Operating income is total revenue less operating expenses, and does not include either interest and other income, net, or income taxes. Identifiable assets of geographic areas are those assets used in Apple's operations in each area. Corporate assets are cash and temporary cash investments.

Supplementary Financial Information Adjusted for Changing Prices (Unaudited)

The Financial Accounting Standards Board requires that certain companies measure and report the effects of changing prices and inflation on their operations. The information required adjusts the historical operating expenses and depreciation of the primary statement of income related to inventories and property, plant, and equipment to reflect the impact of inflation and to adjust those specific items to their present-day cost (current cost). Apple does not restate inventories and cost of sales, as historical cost approximates current cost. The only item that would cause the primary statement of income to be restated is the depreciation component related to property, plant, and equipment. Since the impact of this item does not cause a material difference between the amounts reported on a historical dollar basis and those on a current cost basis, the information as required related to current cost has not been presented. Additionally, the impact of inflation (purchasing power gain or loss) on Apple's net monetary position has not been material.

Report of Certified Public Accountants

To the Shareholders and Board of Directors of Apple Computer, Inc.

We have examined the accompanying consolidated balance sheets of Apple Computer, Inc. at September 26, 1986, and September 27, 1985, and the related consolidated statements of income, shareholders' equity, and changes in financial position for each of the three fiscal years in the period ended September 26, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the consolidated financial position of Apple Computer, Inc. at September 26, 1986, and September 27, 1985, and the consolidated results of operations and changes in financial position for each of the three fiscal years in the period ended September 26, 1986, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

San Jose, California

October 13, 1986

Board of Directors

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General Partner
Venrock Associates
Venture capital investments

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Senior Vice President, Secretary,
and General Counsel
Apple Computer, Inc.

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Private flight service

Arthur Rock
Principal, Arthur Rock & Co.
Venture capital investments

Philip Schlein
Partner, U.S. Venture Partners
Venture capital investments

John Sculley
Chairman, President, and
Chief Executive Officer
Apple Computer, Inc.

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Company Profile

Apple Computer, Inc. develops, manufactures, and markets personal computer systems—the productivity tools of the 1980s—for business, education, science, industry, and the home.

Stock Trading

Apple Computer's common stock is traded on the over-the-counter market and is listed on the NASDAQ National Market System under the symbol AAPL. Options are traded on the Chicago Board Options Exchange and the American Stock Exchange.

Transfer Agent and Registrar

The First National Bank of Boston

Certified Public Accountants

Arthur Young & Company
San Jose, California

SEC Form 10-K

If you would like a copy of our Annual Report on SEC Form 10-K for the fiscal year ended September 26, 1986, you may obtain it without charge. Direct your request to Investor Relations, Apple Computer, Inc., 20525 Mariani Avenue, Cupertino, California 95014.

Corporate and Investor Information

Please direct inquiries to
Investor Relations, Apple Computer, Inc.,
20525 Mariani Avenue, Cupertino, California 95014.

Shareholder's Change of Address

You may report a change of address by sending a signed and dated letter or postcard stating the name in which the stock is registered, and the previous and current addresses. Mail to
The First National Bank of Boston,
Shareholder Services Division, P. O. Box 644,
Boston, Massachusetts 02102.

Annual Meeting

The annual meeting of shareholders will be January 28, 1987, at 10 A.M. at Flint Center, De Anza Community College, 21250 Stevens Creek Boulevard, Cupertino, California.

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